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In the Supreme Court

OF THE
United States

OCTOBER TERM, 1939

No. **1039** 100 ✓

E. R. HAWKE,

Petitioner,

vs.

GUY T. HELVERING, Commissioner of
Internal Revenue,

Respondent.

**PETITION FOR A WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit,
and
BRIEF IN SUPPORT THEREOF.**

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No.

E. R. HAWKE,

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GUY T. HELVERING, Commissioner of
Internal Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit.

*To the Honorable Charles Evans Hughes, Chief
Justice of the United States, and to the Asso-
ciate Justices of the Supreme Court of the
United States:*

E. R. HAWKE prays that a Writ of Certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in the above-entitled cause on February 26, 1940, affirming the decision of the Board of Tax Appeals in part.

JURISDICTION.

The judgment of the Circuit Court of Appeals affirming the decision of the Board of Tax Appeals in part and reversing it in part, was entered on February 26, 1940. (R. 238.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925. (43 Stat. 938, 28 U. S. C. A. Sec. 347 (a).)

STATEMENT OF THE CASE.

The following facts pertinent to the issues here involved were taken from the memorandum opinion of the Board of Tax Appeals, a partial stipulation of facts, and the transcript of the record before the Board.

This appeal involves income taxes for the years 1930 and 1931. Petitioner was first employed by the J. C. Penney Company, a corporation, in 1913 and remained continuously in its employ until May, 1933. From 1919 until he left the employ of the Company in 1933, he was the manager of the Penney Company's store at Modesto, California. Under the corporate set-up of the J. C. Penney Company, each of its stores was individually capitalized under what was known as a classified common stock structure, there being a separate stock classification for each store. The Modesto, California, store was capitalized originally for \$6000.00, and, as manager of the store, Petitioner was permitted to, and did, purchase one-third of the classified common stock of said store. Under an oral

contract of employment he received a salary of \$75.00 per month and, in addition, received one-third of the profits of the store because of his ownership of one-third of the classified stock of that store. (R. 82-84, 167.) At the end of the calendar year of 1926, he was the owner of sixty (60) shares of the classified common stock No. 97 of the Modesto store, which constituted one-third of the capitalization of said store. (R. 88, 167.) In April, 1927, due to a change in the corporate structure of the J. C. Penney Company, Petitioner's classified common stock in said store was called in by the Company and he received in full payment or exchange therefor, 100 shares of the preferred stock of the Company. (R. 88-89, 97-98, 167.) At the same time he was re-employed by the Company as manager of the Modesto store under a written employment contract, which became effective as of January 1, 1927. (R. 86-97, 167.) Said contract provided among other things:

"First: The Associate agrees to continue as manager of said store *and to devote his entire time and the best of his ability* to the successful prosecution of his duties as such,

Second: The Company agrees—

(a) Commencing January 1, 1927, to pay to such Associate each year as added compensation, in addition to the regular salary received by him the same fractional portion of the net earnings of said store for which said Associate is manager as he would have been entitled to, had he continued to own and hold said shares of classified common stock which he has delivered to the Company for conversion * * * (R. 89, 90.)

The contract further provided:

"Fourth: The Company further agrees with the Associate that when by reason of death, disability, or for any other reason, the Associate shall cease * * * to be the manager of such store, the Company will sell to him (or if he ceases to be manager by reason of death, then to his legal representatives or next of kin) at the *then* book value, and he or his legal representatives or next of kin shall have the right to purchase by paying such price, a sufficient number of shares of common stock of the Company, the earnings on which based upon the net earnings of the Company for the last full calendar year, will equal in amount two-thirds of the Associate's proportion (as fixed by paragraph Second hereof) of the average annual net earnings of such store for three full calendar years * * *" (R. 91, 92.)

"Seventh: This and all other manager's conversion contracts are entered into by the Company with the respective Associate upon the Express condition and reservation that if the Board of Directors of the Company deem it necessary or advisable in their discretion, by reason of structural corporate changes, reorganization, dissolution or sale of corporate assets, the Company may call in and terminate all manager's conversion contracts at the end of any calendar year upon paying to each Associate entering into such a contract the amount due to him under paragraph Second hereof and upon permitting each such Associate to exercise his right to purchase the amount of common stock to which he is entitled under paragraph Fourth hereof." (R. 93.)

"Tenth: This contract shall be binding on the parties hereto, their next of kin, legal representa-

tives, successors and assigns, *and it is specifically understood that this is a personal service contract* and that the right to receive added compensation as herein provided and the right to purchase common stock cannot be assigned by the Associate." (R. 94.)

In March, 1929, Petitioner received a letter from the J. C. Penney Company advising him of the intention of the Company to cancel his manager's contract of April, 1927. (R. 99-101.) By letter dated March 18, 1929, Petitioner was advised by the Company that his manager's contract of April, 1927, was cancelled as of December 31, 1928, and that, pursuant to the terms of said contract, he had the right to buy 971 shares of the Company's common stock at a price of \$28.00 per share. (R. 101-104, 167-8.) Petitioner exercised his right to buy the stock and purchased 971 shares at a price of \$28.00 per share. (R. 168.) (It was stipulated that the purchase was made on or about March 18, 1929, and that the fair market value of said stock at the time of purchase was \$367.50 per share.) (R. 163, 168.) Petitioner was re-employed by the J. C. Penney Company as manager of the Modesto, California, store under a written contract dated April 15, 1929, as of January 1, 1929. The new contract did not include any stock purchase rights and the percentage of store earnings to which Petitioner was entitled as compensation was materially reduced. (R. 168.)

In 1930 and 1931 the Petitioner sold certain shares of said 971 shares of stock purchased under the employment contract in 1929. The Respondent after

auditing Petitioner's tax returns for the years 1930 and 1931, assessed a deficiency against Petitioner arising from the sale of said stock and other stock not involved in this appeal. In the determination of the deficiencies, the Respondent used as the cost basis of the said shares to the Petitioner the amount of money which he paid in the acquisition of them. (R. 172.) The Petitioner appealed to the Board of Tax Appeals contending that the proper basis to be used in determining his loss or gain on the sale of said stock was the fair market value of the stock at the date of its acquisition. The Board held that the differential between the price paid by Petitioner for said 971 shares and the fair market value thereof at the date of acquisition was not compensation for services and sustained the cost basis used by Respondent (i. e., the amount of money Petitioner paid for the shares). (R. 181, 182, 183.)

The Court below held "that where there is a 'bona fide' sale from an employer to an employee, at less than market value, * * * Art. 51, Reg. 74, 1928 Rev. Act (Appendix p. ii) cannot transform such purchase * * * into taxable income on the part of the purchaser * * *." (R. 225.) The Court below further held that it was unnecessary for it to decide whether the differential as to the stock in issue constituted additional compensation (R. 233), and sustained the cost basis used by Respondent in determining a deficiency.

QUESTIONS PRESENTED.

The taxpayer in March, 1929, purchased stock of his employer pursuant to an employment contract in evidence, dated April 25, 1927, at a price in money substantially less than fair market value. The price per share which he was to pay for the stock and the number of shares which he was entitled to buy being determinable upon the cancellation of the contract by the company upon the basis of a formula contained therein. The company canceled the contract in March, 1929, and Petitioner exercised his right to buy the stock. The questions are:

1. Did taxpayer receive taxable income in 1929 to the extent of the difference between what he paid his employer in money for 971 shares of stock and the fair market value thereof at the time of purchase, when the right to purchase the stock at "bargain prices" was contained in the contract of employment and the excess value of the stock over and above the amount of money paid was (a) in the nature of compensation for services rendered, or (b) liquidated damages or a penalty imposed on the employer for the cancellation of the contract?

2. Where property is sold by an employer to an employee for an amount of money substantially less than its fair market value and the differential is income to the employee because it is either in the nature of compensation for services rendered, or by way of liquidated damages or the payment by the employer of a penalty imposed for the cancellation of an em-

ployment contract, is it not proper for the employee to use the fair market value of the property at the time of acquisition as his cost basis in determining his profit or loss on the subsequent sale?

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are set forth in the Appendix, *infra*, pages i-ii.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

1. The decision of the Circuit Court of Appeals for the Ninth Circuit that the "bargain purchase" of 971 shares of stock by Petitioner in 1929 did not result in taxable income to him in that year is in direct conflict with the decision of the Circuit Court of Appeals for the Second Circuit in the case of *Salvage v. Commissioner*, 76 F. (2d) 112, affirmed by this Court in 297 U. S. 106, 56 S. Ct. 375, 80 L. Ed. 511, and is also in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Robinson v. Commissioner*, 59 F. (2d) 1008.

2. The decision of the said Circuit Court of Appeals as to the proper cost basis to be used by the Petitioner in reckoning his income tax in the years the stock was sold is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit and with the decision of this Court in the case of

Salvage v. Commissioner, supra, and with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Robinson v. Commissioner*, supra.

3. The decision of the said Circuit Court of Appeals, both as to the question of income arising from "bargain purchases" and as to the proper cost basis to be taken by taxpayer, is a decision of important federal questions which are in conflict with applicable decisions of this Court and particularly in conflict with the decision of this Court in the case of *Salvage v. Commissioner*, supra.

4. The decision in the case of *Omaha National Bank v. Commissioner*, 75 F. (2d) 434 (C. C. A. 8th), relied upon and adopted by the Circuit Court of Appeals for the Ninth Circuit in holding that "a bona fide sale from an employer to an employee, at less than market value * * * cannot transform such purchase * * * into taxable income on the part of the purchaser" is in conflict with, and in effect overruled by, the decision of the Circuit Court of Appeals for the Seventh Circuit in the case of *Indianapolis Glove Co. v. U. S.*, 96 F. (2d) 816.

5. The decision of said Circuit Court of Appeals in holding that there was a "bona fide sale" of 971 shares of stock to taxpayer instead of a purchase of stock from which taxable income arose is contrary to the law and the evidence.

6. The question of whether payments made for the cancellation of an employment contract by means of permitting the employee to purchase stock of the em-

ployer at prices substantially below its fair market value constitute taxable income to the employee in the year of the acquisition of the stock to the extent of the differential between the price paid and fair market value is an important question of income taxation not heretofore determined by this Court.

7. The question of whether taxable income results from "bargain purchases" under circumstances similar to the facts in the instant case and the proper cost basis in determining loss or gain on subsequent sales are involved in a number of cases now pending before the Bureau of Internal Revenue and the Courts, and will arise in subsequent cases. Accordingly, to attain uniformity of decision, to obviate confusion on the part of tax authorities and lower Courts, and to serve as a guide in determining what is income in cases involving a situation that is very common and continually recurring, a clear-cut decision by this Court would be of great value.

CONCLUSION.

For the reasons above stated, Petitioner respectfully submits that this Petition should be granted.

Dated, Oakland, California,
May 22, 1940.

E. R. HAWKE,

Petitioner.

ALAN W. DAVIDSON,

Counsel for Petitioner.

In the Supreme Court
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OCTOBER TERM, 1939

No.

E. R. HAWKE,

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vs.

GUY T. HELVERING, Commissioner of
Internal Revenue,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

OPINIONS OF THE COURT BELOW.

The opinion of the Board of Tax Appeals (R. 165-186) is unreported. The opinion of the Circuit Court of Appeals (R. 216-237) is reported in 109 F. (2d) 946.

For the sake of brevity, we refer to the preceding Petition for the following:

Jurisdiction.....(supra, page 2); and
Statement of the Case.....(supra, page 2).

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are set forth in the Appendix, *infra*, pages i-ii.

SPECIFICATION OF ERRORS TO BE URGED.

Petitioner submits that the Circuit Court of Appeals erred:

1. In holding that the cost basis of 971 shares of stock acquired by Petitioner in 1929, pursuant to the terms of an employment contract, upon its cancellation, was the amount of money he paid for them, instead of the fair market value thereof at the time of acquisition.

2. In holding that the acquisition of said 971 shares by Petitioner was merely a "bona fide purchase", or ordinary sale, in which no taxable income occurred at the time of acquisition, instead of holding that the transaction resulted in taxable income at the time of acquisition to the extent of the differential between the amount of money paid for the stock and its fair market value.

3. In failing to find and hold that the differential between the price paid by Petitioner for said 971 shares of stock and its fair market value at the time of acquisition was in the nature of (a) compensation paid to him for services rendered, or (b) liquidated damages or the payment to him by the employer of a penalty imposed for the cancellation of the employment contract.

4. In holding that Petitioner realized a taxable gain on the sale of said shares of stock in the years 1930 and 1931.

SUMMARY OF ARGUMENT.

When the taxpayer, in 1929, purchased 971 shares of corporate stock of his employer, J. C. Penney Company, pursuant to the terms of an employment contract entered into in 1927, and cancelled in March, 1929, at a price substantially below the fair market value of the stock at the time of acquisition, he realized taxable income in the year 1929 to the extent of the difference between the amount of cash he paid for the stock and its fair market value, either because (a) the differential was in the nature of payment of compensation for services rendered to the company, or (b) by way of liquidated damages or the payment to him by the company of a penalty for the cancellation of the employment contract.

Hence, the proper capital base under the statute for determining his loss or gain on the subsequent sale of the stock in 1930 and 1931 was the fair market value of the stock at the date of acquisition and not the amount of money paid for it. (Treas. Reg. 74, Art. 51; Secs. 22(a); 111(a); 113(a) Rev. Act 1928; Appendix pp. i-ii.)

ARGUMENT.

THE DIFFERENTIAL BETWEEN THE AMOUNT OF CASH PAID BY PETITIONER FOR THE STOCK AND ITS FAIR MARKET VALUE WAS TAXABLE INCOME IN 1929.

(a) BECAUSE IT WAS IN THE NATURE OF COMPENSATION FOR SERVICES RENDERED.

What is or is not "income" within the meaning of the Sixteenth Amendment to the Constitution must be determined in each case according to truth and substance, without regard to form—*Eisner v. Macomber*, 252 U. S. 189, 206, 207, 40 S. Ct. 189, 193, 64 L. Ed. 251.

See also:

Weiss v. Stearn, 265 U. S. 242;

Alger-Sullivan Lumber Co. v. Commissioner,
57 F. (2d) 3.

It has been a long established principle of law that where shares of stock are received as compensation for services they must be included in gross income at their fair market value in the year when received, for the statute requires that there shall be included in gross income:

"gains, profits and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid."

Revenue Act of 1928, Sec. 22 (a) (Appendix, p. i);

Old Colony Trust Co. v. Commissioner, 59 Fed. (2d) 168 (C. C. A. 1st);

Crowell v. Commissioner, 62 Fed. (2d) 51 (C. C. A. 6th);

Olson v. Commissioner, 67 Fed. (2d) 726 (C. C. A. 7th), certiorari denied 292 U. S. 637.

Where an employee, as part of his compensation, is permitted to buy stock from his employer at a price below the fair market value, the differential between the fair market value of the stock and the price paid for it by the employee has long been held to be taxable income to the employee in the year in which the stock was acquired.

Reg. 74, Art. 51, Rev. Act of 1928 (Appendix p. ii) (based on T. D. 3435—promulgated in 1923);

Robinson v. Commissioner, 59 Fed. (2d) 1008 (C. C. A. 6th);

Salvage v. Commissioner, 76 Fed. (2d) 112, affirmed in 297 U. S. 106, 56 S. Ct. 375, 80 L. Ed. 511.

The Board of Tax Appeals has repeatedly recognized this principle.

See:

Albert Russell Erskine, 26 B. T. A. 147;

Phillip W. Haberman, 31 B. T. A. 75;

Chas. M. Thorp, 32 B. T. A. 767;

Hudson Motor Car Co. v. U. S., 3 F. Supp. 834;

E. D. Knight, 28 B. T. A. 188.

During the past two decades, many corporate plans to compensate employees by means of permitting them to buy stock at "bargain prices" and other plans for services rendered the corporation have been devised. These various plans have numerous ramifications and the Courts have been called on repeatedly to determine the question of taxability of income arising from them.

See:

Noel v. Parrott, 15 Fed. (2d) 669, certiorari denied, 273 U. S. 754;

Commissioner v. Bonwit, 87 Fed. (2d) 764, 765;

Levy v. Helvering, 68 Fed. (2d) 401;

Alger-Sullivan Lumber Co. v. Commissioner, 57 Fed. (2d) 3;

Indianapolis Glove Co. v. U. S., 96 Fed. (2d) 816.

An exception to the well established principle that a sale of stock to an employee at "bargain prices" creates taxable income to the extent of the differential between the amount of cash paid and the fair market value of the stock (see *supra*) has arisen on the theory that where there is a "bona fide", or ordinary, sale from an employer to an employee, at less than market value, the differential does not constitute income within the meaning of the statute defining "gross income". We have been unable to find any case involving this theory which has come before this Court. The Lower Court (R. 225, 230-232) and the Board (R. 176, 182, 183) applied this theory to the facts here and, adopting the rule laid down in the cases of *Commissioner v. Van Vorst*, 59 F. (2d) 677 (C. C. A. 9th), and *Omaha Bank v. Commissioner*, 75 F. (2d) 434 (C. C. A. 8th), have held that the purchase of 971 shares of stock by Petitioner under the employment contract, even though at a price considerably less than fair market value, was a "bona fide", or ordinary, sale and no taxable income resulted.

Your Petitioner contends that the facts in the *Commissioner v. Van Vorst* (supra) and *Omaha Bank v. Commissioner* (supra) cases have no similarity whatsoever to the situation here and the principle of law applied in those cases has no application to the facts here involved. In the *Van Vorst* case the taxpayer purchased from a corporation of which he was the principal stockholder certain real estate at a price below the fair market value of the property at the time of purchase. The amount paid for the property was equal to the cost of the property to the corporation. (59 F. (2d) at 678.) The Commissioner assessed a deficiency for the differential between the amount paid by the taxpayer and the fair market value of the property on the theory it was taxable income under the provisions of T. D. 3435 (identical with Reg. 74, Art. 51, here involved). The Board of Tax Appeals decided that the determination of the Commissioner was erroneous. On the Commissioner's appeal, the Ninth Circuit Court sustained the Board and held that the transaction was not taxable as a distribution of corporate assets or earnings and T. D. 3435 did not apply. It was not contended that the "bargain purchase" was intended to compensate the taxpayer for services rendered the corporation; no contract of employment was involved and there was no evidence that the transaction was intended as a distribution of corporate assets. In the *Omaha Bank* case (supra) the facts are briefly these:

In 1918 an employee (taxpayer) entered into a written agreement with his employer (a corporation) wherein he agreed to buy, and the employer

agreed to sell 500 shares of the corporation's stock for \$50 per share. The agreement further provided that the employer was to allow credits on the agreement equal to dividends on the 500 shares and if at the end of a term of years said allowances did not equal the price of a certain number of the shares, the employee was to receive the shares outright. In 1928 the Company credited the employee's account under the contract with \$7500 and issued to him 150 shares pursuant to the terms of the agreement. At that time the stock had a fair market value of \$59,568.75. The employee returned the sum of \$7500 as taxable income in his 1928 tax return. The Commissioner took the position that the taxpayer had received as additional compensation the fair market value of the stock, instead of \$7500, and calculated a tax accordingly. Upon appeal, the Board of Tax Appeals sustained the Commissioner. The Circuit Court in reversing the Board said (pp. 435, 436):

"The Commissioner and the Board have treated the transaction here involved as one in which the company in 1928 delivered 150 shares of stock to the taxpayer as additional compensation for services. They have disregarded the contract. * * * Concededly, if the company had, without any previous agreement or understanding, credited the taxpayer with \$7,500 and delivered to him the 150 shares of stock as additional compensation for his services, the realized gain would be the fair market value of the stock. (Citing cases.) But where the stock was delivered under a *contract of purchase* and the taxpayer became the owner of it because of his *agreement to purchase*, the difference between what he paid for the stock and what the stock

was worth was not a taxable gain." (Citing *Commissioner v. Van Vorst*, supra.)

It is to be noted that the contract there involved was purely a bilateral agreement to purchase and sell. The employee was bound to buy and the employer bound to sell. It was not a contract of employment. The price per share and the number of shares was definitely fixed by the contract. As far as can be determined from the record, the purchase of the stock was in no way dependent upon the employee's continued affiliation with the company. The employee was not bound to continue in the employ of the company. The contract apparently was assignable.

The facts in this appeal and the facts in the *Omaha National Bank* case (supra) are so greatly dissimilar that it is difficult to understand the Circuit Court's comparison of the two cases. The salient features of the contract here involved may be summarized as follows:

1. The contract was essentially an employment contract. (R. 94.)
2. The Petitioner was bound to devote his entire time and the best of his ability to the prosecution of his duties as store manager. (R. 89.)
3. The right to purchase the stock was an integral part of the employment contract and was dependent upon Petitioner's service to the company. (R. 91.)
4. Petitioner was not bound to buy the stock—upon the happening of certain conditions subse-

quent, he became entitled to exercise the right to purchase at his discretion. (R. 91, 92.)

5. The price per share to be paid by Petitioner was determinable at the termination of his services, or at the time of the cancellation of the contract. (R. 91, 92.)

6. The number of shares which Petitioner would be entitled to buy was dependent upon his earnings under the contract over a period of three years. (R. 91, 92, 88, 89.)

7. The right to purchase stock was not assignable. (R. 94.)

In construing the motive of the employer in this case, in the light of the language used by the Court of Appeals, D. C., in the case of *Levy v. Helvering*, 68 F. (2d) 401, the conclusion is inescapable that the Penney Company intended to compensate Petitioner for his services rendered, and to be rendered, by enriching him to the extent of the differential between a nominal price to be paid for its stock and its substantially higher market value. The Court in the *Levy* case (*supra*) said:

“In most of the cases in which the question has arisen (whether compensation or gift) the answer has been made to depend on the intention of the parties, and this usually and properly has been said to turn on the attending facts and circumstances. Ordinarily to ascertain the intention with which a thing is done one looks to the motive impelling it. Here the motive is obvious. The payment was authorized to secure to certain of the corporation’s executives the payment of

their stipulated salaries undiminished by taxation. * * * The test is whether it was in payment of services. Here there was consideration—viz.: an acknowledgment and reward for services rendered in the preceding years and a stimulus to continued effort and service in the ensuing year.”

The facts in this case are strikingly similar to those found in *Albert Russell Erskine v. Commissioner*, 26 B. T. A. 147 (a leading Board case on this point). In that case, Erskine in 1922 entered into an agreement to work for the Studebaker Corporation for a term of years. The contract provided that petitioner should receive a cash salary and have the right and option to buy and receive a certain number of shares of preferred and common stock of the corporation, to be determined upon the basis of the annual profits of the corporation, and upon payment to the corporation of a nominal price per share. The corporation purchased the shares in the open market at a cost several times the agreed price to Erskine and placed them in escrow subject to the terms of the agreement. In holding that the difference between the price paid by Erskine and the fair market value of the stock at the time of purchase was compensation taxable to Erskine, the Board said (26 B. T. A. 147, at 156):

“We are convinced from a study of the instrument itself and the circumstances disclosed by the evidence that the agreement must be considered primarily as a contract of employment. * * * We see no basis for construing that portion of the agreement relating to the petitioner’s rights to acquire the shares of stock separately as a

contract of purchase and sale. In the first place, the petitioner was not obliged to purchase the stock, but might do so at his own option, contingent upon the corporation's profits. The only true consideration for which the petitioner was obligated was his promise to serve the corporation for the period covered by the agreement. This consideration undoubtedly extended to all of the provisions of the contract. * * *

Page 161:

"There is ample evidence that petitioner's rights to acquire the stock were 'in the nature of compensation for services rendered' or a 'bonus'. The petitioner here could not have bought his shares of stock until he had performed the services required of him. He assumed no risk in the possible event of a subsequent decline in the market value of the shares below the price named in the agreement because he was under no obligation to purchase them."

See also:

Robinson v. Commissioner (supra);

Alger-Sullivan Lumber Co. v. Commissioner,
57 F. (2d) 3.

Petitioner not only contends that the principle adopted in the *Omaha Bank* case (supra) is inapplicable here, but also that the decision cannot be reconciled with the decision of the Circuit Court for the Seventh Circuit in the case of *Indianapolis Glove Co. v. U. S.*, 96 F. (2d) 816, involving facts similar to the facts in the *Omaha Bank* case. In the *Indianapolis*

Glove Co. case, the company in 1925 offered to sell a number of shares of its stock to certain employees at par, accepting the employees notes and holding the stock in the names of the employees as collateral security. Dividends were to be applied to the notes and the notes cancelled when the dividends equaled the face amounts of the notes. During 1925 to 1929, cash dividends were paid to the employees on such stock. None of the dividends were applied on the promissory notes and no payments were made thereon by the makers. In August, 1929, the stock had a book value of \$200.00 and the stock was changed from common stock of \$100.00 par value to no par value on the basis of four shares of no par stock for one share of \$100.00 par value stock. The old notes given by the employees were cancelled, new notes given for the same amounts and half of the new stock was delivered to the employees. The remaining one-half of the new stock was retained as collateral security for the new notes. The stock received by the employees had a market value of \$159.50 when issued to them. The Company was allowed to treat the market value of the stock in 1929 as a deduction for compensation paid in that year, the Court holding:

“We are of the opinion that there was no intention on the part of either appellee or its employees that the transaction of June, 1925, should constitute a sale of the shares of stock. On the contrary, we think it was their intention and understanding to provide a plan by which the employees were to receive additional compensation for services rendered.”

Here again is a case in which it did not specifically appear that the employees were bound to continue their services to the company. The Court, however, held that the fact was that the employees did remain in the company's service and the only conclusion that could be reached was that it was implied that they should do so. No such doubt exists in this case. The taxpayer was bound to remain in the company's service and devote his entire time to the business. (R. 89.) The question of whether such compensation (i. e., the differential) was received for services rendered or to be rendered, or for the cancellation of the contract, is to be determined from the contract itself. It is our contention that this case falls squarely within the provisions of Sec. 22 (a) Rev. Act 1928 and Reg. 74, Art. 51 (Appendix, pp. i-ii) under the authority of *Robinson v. Commissioner* (supra) and *Salvage v. Commissioner* (supra). The facts in the *Robinson* case may be briefly stated as follows: In 1911, the taxpayer began working for the corporation at only a nominal salary learning the business. Several years later (1915) he had risen to a position of comparative importance and had received an offer of employment from another corporation which he discussed with his employer. To induce him to stay with his employer, he was offered 200 shares of common stock of the company at a price of \$200.00 per share, notwithstanding the market value of the stock at the time of acquisition was considerably more. The question involved was whether the actual money cost of \$200.00 per share (as held by the Board of Tax Ap-

peals) or the market value of the stock at the time of acquisition was to control in fixing the capital base. The Circuit Court held (C. C. A. 6th) (P. 1009):

“The excess value was either intended as a gift * * * or in the nature of compensation for past or future services in the interest of the company. * * * Whether regarded as a gift, or as compensation, the surplus value over and above the actual price paid for the shares must be taken into consideration in determining capital base, and that such base is to be fixed at the true or market value at the time the stock was acquired.” (T. D. 3435—afterwards incorporated in the Regulations, and identical with the regulations here involved, was cited in the opinion.)

The effect of the provisions of T. D. 3435 was squarely before the Court in the case of *Salvage v. Commissioner* (supra). In that case, the taxpayer had received a certain number of shares of stock worth \$1164.70 per share at the par value of \$100.00 each, in consideration of his covenant not to engage in a competing business. One of the questions involved was whether the transaction came within the provisions of T. D. 3435. The Circuit Court (C. C. A. 2nd) held (76 F. (2d) at 113):

“Although there is no suggestion in the language quoted (T. D. 3435) that the property sold for less than its fair market value must be intended to be compensation to an employee for past or future services or in the nature of a dividend to a shareholder, the article has properly been so limited.” (Citing cases.)

* * * * *

"But where the excess value is in the nature of compensation for services it does constitute taxable income when received." (Citing *Robinson v. Commissioner* (supra); *Rodrigues v. Edward*, 40 F. (2d) 408.) "In the case at bar the Board found that the stock was not acquired by the Petitioner as compensation for services. The correctness of this finding is disputed, but, * * * we must accept it as a finding of fact.

Nevertheless, the Commissioner is not aided thereby. The contract under which the Petitioner purchased the 1,500 shares of Viscose stock stated that the consideration for selling it at less than its real value was the Petitioner's covenants relating to the option and to his refraining from engaging in a competing business. Compensation paid for refraining from labor would seem to be taxable income no less than compensation for services to be performed. * * * The statutory definition of gross income is exceedingly broad. (Section 213, Rev. Act 1921.) We cannot avoid the conclusion that a payment for a covenant not to engage in a certain business should be deemed 'income' of the recipient of the payments."

This Court sustained the decision of the Circuit Court (297 U. S. 106) and upheld this construction of the statute and regulation involved.

Looking at the four corners of the contract of employment, it is evident that the company was desirous of continuing the services of the taxpayer. (R. 89.) The provision relating to the purchase of stock was undoubtedly intended as an incentive to Petitioner to put forth every effort to run his store successfully.

The number of shares which he became entitled to buy at the time of the cancellation of the contract depended upon his earnings over a three year period. (R. 91, 92.) What more impelling consideration could there be for the company's agreement to sell him stock at prices far below fair market value than his services to the company?

"A corporation may not lawfully give away its property in order to gratify an individual, hence there is a presumption that payments beneficial to an employee are intended as additional compensation, rather than gifts."

Commissioner v. Bonwit, 87 F. (2d) 764.

THE DIFFERENTIAL BETWEEN THE AMOUNT OF CASH PAID BY PETITIONER FOR THE STOCK AND ITS FAIR MARKET VALUE WAS TAXABLE INCOME IN 1929, IF NOT COMPENSATION FOR SERVICES, THEN

(b) **BECAUSE IT WAS BY WAY OF LIQUIDATED DAMAGES OR THE PAYMENT TO HIM BY THE COMPANY OF A PENALTY FOR THE CANCELLATION OF THE EMPLOYMENT CONTRACT.**

As we have previously contended, the question of whether the differential was received for services rendered, or to be rendered, or by way of liquidated damages or the payment of a penalty for the cancellation of the contract is to be determined from the contract itself. The contract specifically reserved unto the company the right to call in and terminate the contract at the end of any calendar year upon the payment to Petitioner of his percentage of the earnings of the store *and upon permitting him to exercise his right to purchase the stock* in question according to the

terms of the contract. (R. 93.) Does not this provision have the legal effect of liquidated damages, or the payment of a penalty for cancellation? The Petitioner had a very lucrative contract of employment. In addition to his regular salary, he also received one-third of the net earnings of the store. (R. 89.) For the three year period immediately preceding the cancellation of the contract, this one-third averaged over \$20,000.00 a year. (R. 104.) Under the old corporate set-up, Petitioner was entitled to receive the same percentage of the net earnings of the store solely by virtue of his ownership of one-third of the classified stock of the store. (R. 167.) In 1927, the company reorganized and called in the classified common stock, paying preferred stock in full payment thereof. (R. 167.) The right of Petitioner to continue to receive one-third of the store's earnings, however, was maintained by express provision in the employment contract. The company, however, reserved the right to terminate this lucrative arrangement by cancellation of the contract. We contend that the stock purchase provision was clearly intended to compensate Petitioner, upon cancellation, for the loss of his valuable right to receive a percentage of the store earnings. Unquestionably the termination of this right was of great value to the company. Upon cancellation of the 1927 contract, Petitioner was reemployed by the company. The new employment contract did not include any stock purchase rights and the percentage of store earnings to which the Petitioner was entitled was materially reduced. (R. 168.)

We have been unable to find any case decided by this Court which involves the payment of liquidated damages, or the payment of a penalty for the cancellation of a contract through the medium of selling property at a price less than fair market value. The Board of Tax Appeals has, on several occasions, held that an amount received by an employee from his employer in consideration of the cancellation of a contract of employment constitutes income under the statute defining "gross income".

See:

George K. Gann, 41 B. T. A. 57;¹

Thurlow E. McFall, 34 B. T. A. 10;

August Merckens, 7 B. T. A. 32;

Earl Groth, 32 B. T. A. 796.²

An amount received by a taxpayer as compensatory damages for breach of warranty in a contract has been held by this Court to constitute income in the year of its receipt.

Burnet v. Sanford & Brooks Co., 282 U. S. 359.

It is common business practice to secure a release from an uncomfortable contract by paying for its cancellation. Payments in cancellation of existing agreements are made in substitution of the future earnings originally contemplated rather than in per-

1. Citing *Eisner v. Macomber* (supra); *Walter M. Hort*, 39 B. T. A. 922 (on appeal to C.C.A. 2nd) involving the payment of a sum of money for the cancellation of a lease; *H. J. Josey*, 38 B. T. A. 497, affd. 104 F. (2d) 453 (lease cancellation); *T. E. McFall*, 34 B. T. A. 108 (cancellation employment contract).

2. The Board held in this case that a sum of money received for the cancellation of an employment contract was ordinary income and not earned income within the meaning of Sec. 31 (a)(1) Rev. Act. 1928.

formance of the obligation to pay them. It can be generally said that such payments are income to the recipient. This rule obtains with respect to contracts of employment.

Paul & Mertens Law of Federal Income Taxation, Vol. 1, Sec. 7.49, p. 278.

The situation here is analogous to *Salvage v. Commissioner* (supra) where the differential was held compensation for an agreement not to engage in a competing business and thus was taxable income. This rule has been followed in *Beal's Estate v. Commissioner*, 82 F. (2d) 279.

Clearly, the Board of Directors of the Penney Company had no authority to make a gift to Petitioner of any part of the value of the shares of stock, or to "sell" them to him at a price known to be considerably less than their market value.

"It needs neither argument nor citation of authority to establish the proposition that the directors were without authority to give away the corporate assets, and that for them to make to several of their members and other persons a gift of a large sum of money from the corporate assets would be neither 'wise' nor 'proper' and would amount to an illegal misapplication of corporate funds. We must assume that the directors did not intend such a flagrant violation of their trust."

Noel v. Parrott, 15 F. (2d) 669, 671. (Certiorari denied 273 U. S. 754.)

Approved by:

Weagent v. Bowers, 57 F. (2d) 679, 682;

Commissioner v. Bonwit (supra).

"Income may be property and is taxable under the same rule as an income in money. *Peabody v. Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152. The language of Sec. 22 (a) of the Rev. Act of 1928 in defining 'gross income' includes the fair market value of property and property rights as well as money. *Crowell v. Commissioner*, 62 F. (2d) 51."

Bartlett v. Commissioner, 71 F. (2d) 601.

In view of these authorities, it clearly appears that, pursuant to the provisions of Sec. 22 (a) Rev. Act 1928, and Reg. 74, Art. 51 (Appendix pp. i-ii) the differential here involved is income in the year of its receipt.

THE FAIR MARKET VALUE OF THE STOCK AT DATE OF ACQUISITION IS THE PROPER CAPITAL BASE FOR DETERMINING LOSS OR GAIN ON SUBSEQUENT SALE.

This question has been discussed at length in the preceding argument. Furthermore, this Court has considered the statutory provisions (Sec. 111 (a); Sec. 113 (a) Rev. Act 1928) (Appendix, *infra*, p. i), and the regulation applicable (Treas. Reg. 74, Art. 51) (Appendix, *infra*, p. ii) to the facts here involved in the case of *Salvage v. Commissioner* (supra). This

Court in affirming the decision of the Second Circuit Court used the following language:

“Also that the base cost for estimating capital gain in 1929 was the fair market value in 1922 of the shares then held * * *

We find no reason to disagree with the judgment of the court. * * *

Pertinent Treasury Regulations, rulings and judicial opinions are adequately pointed out by the court’s opinion.”

We submit that a difference of opinion on this point could have required a reversal of the lower Court. The regulation here involved (Reg. 74, Art. 51, *supra*) is merely a recognition of the principle that a broad rather than a restricted meaning must be given to the word “cost”. Hence, the “cost” of property is the value given in payment of it whether in cash, property or services, or a combination of these. In other words, Sections 111 and 113, 1928 Rev. Act (*supra*) are to be construed in the light of the provisions of Section 22.

CONCLUSION.

It is, therefore, respectfully submitted that this case is one calling for the exercise by this Court of its supervisory power by granting certiorari and thereafter reviewing and reversing that part of the decision of the Lower Court which affirms the decision of the Board of Tax Appeals.

Dated, Oakland, California,
May 22, 1940.

ALAN W. DAVIDSON,
Counsel for Petitioner.

(Appendix Follows.)

Appendix

STATUTE AND REGULATIONS INVOLVED.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 22. GROSS INCOME.

(a) General Definition.—“Gross income” includes gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) Computation of gain or loss.—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

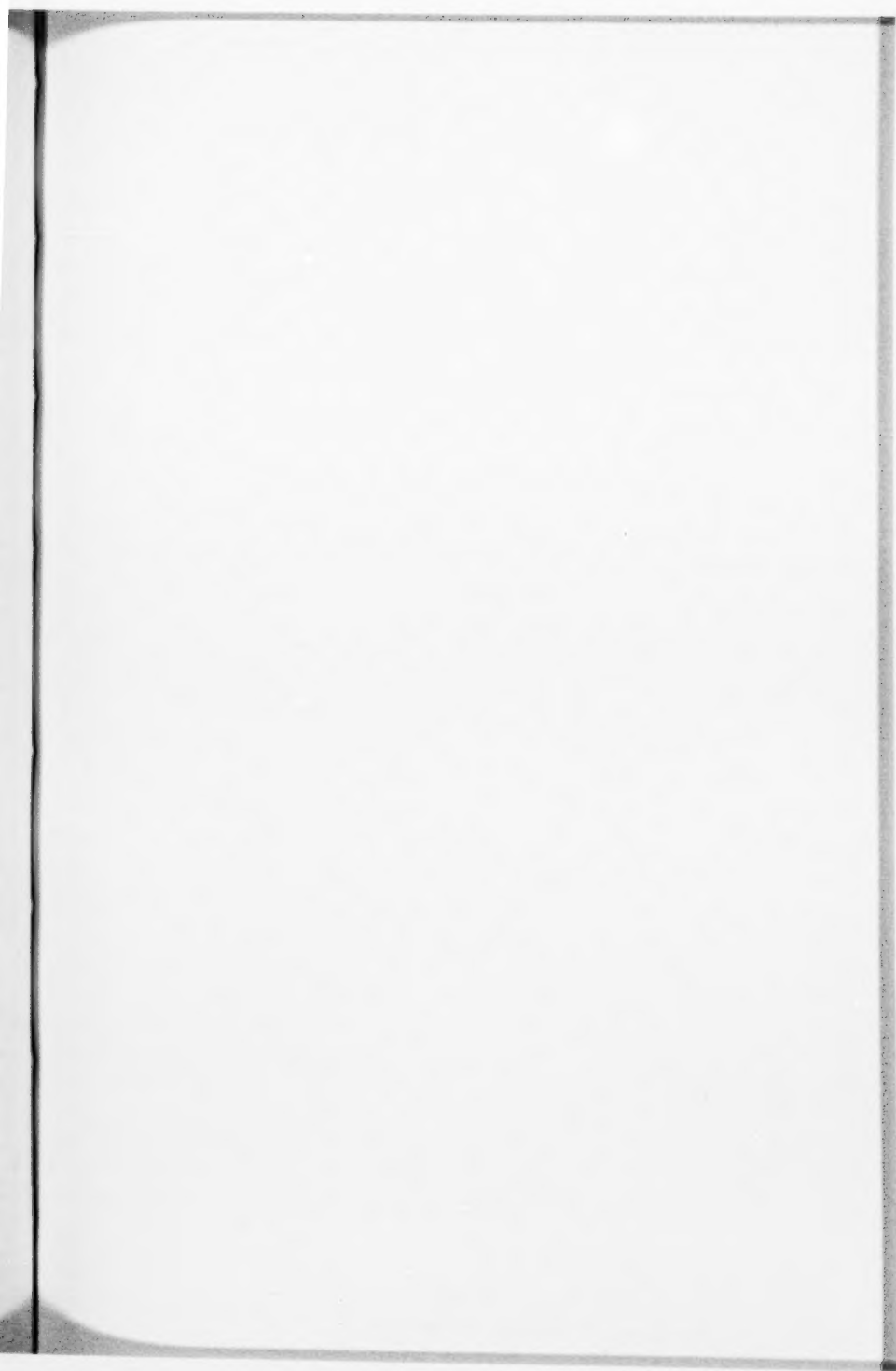
(a) Property acquired after February 28, 1913.—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 51. What included in gross income.—

Where property is sold by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. In computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition by the shareholder or the employee.

* * *



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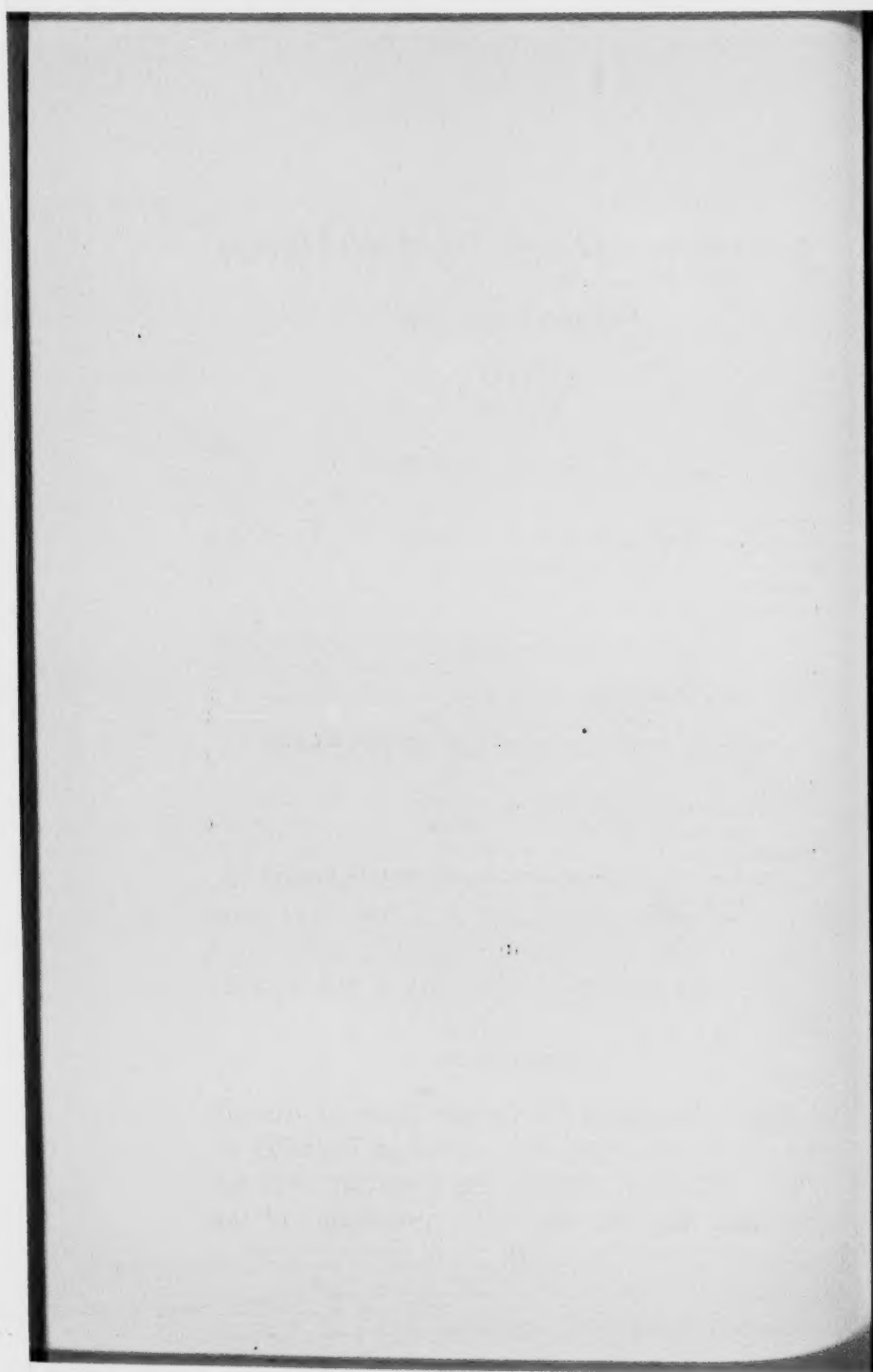
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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 100

E. R. HAWKE, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL
REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE NINTH
CIRCUIT*

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 165-186) is reported in 35 B. T. A. 784. The opinion of the Circuit Court of Appeals for the Ninth Circuit (R. 216-237) is reported in 109 F. (2d) 946.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Ninth Circuit was entered on February 26, 1940. (R. 238.) Petition for a writ of certiorari was filed May 24, 1940. The jurisdiction of this

Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

By a contract of employment executed in 1927, taxpayer received an option to buy certain stock, at book value, upon the termination of his employment. The fair market value of the stock at the time of the contract has not been shown. In 1929, taxpayer purchased such stock, pursuant to the right conferred by the contract, at a price much less than fair market value in 1929. In determining gain upon a subsequent sale, is the basis of the stock its cost or the fair market value in 1929?

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; * * *

* * * * *

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 51. *What included in gross income.*—* * *

Where property is sold by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less

than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. In computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition by the shareholder or the employee. * * *

STATEMENT

The relevant facts, as found by the Board of Tax Appeals (R. 166-172), may be summarized as follows:

In 1927, the taxpayer was, and for many years had been, an employee of the J. C. Penney Company. (R. 166.) By a written contract of April 25, 1927, the J. C. Penney Company reemployed the taxpayer as manager of one of its stores. This contract gave the taxpayer the right, at such time as he ceased to be the manager of the store, to buy at book value certain common stock of the company, the precise amount to be determined in accordance with a formula contained in the contract. (R. 167.) No finding was made, nor was any evidence introduced, as to the fair market value of the stock on April 25, 1927. On March 18, 1929, the J. C. Penney Company informed the taxpayer that it elected to terminate the employment contract of April 25, 1927, and that the taxpayer had the right thereunder to buy 971 shares of common stock at

\$28 per share. (R. 167-168.) Taxpayer immediately exercised this right. At the date of purchase, the fair market value of the stock was \$367.50 per share. (R. 168.) The taxpayer did not include as income in his tax return for 1929 the differential between the fair market value and the price paid for the stock. (R. 170.)

In 1930 and 1931 the taxpayer sold certain shares of this stock. (R. 172.) The question here presented relates to the computation of the profit upon those sales. In determining the deficiencies herein, the Commissioner used as the basis of the shares to the taxpayer, the amount which he actually paid for them, rather than the fair market value at the time of acquisition. (R. 172.) The Board of Tax Appeals sustained the Commissioner's determination, and the court below affirmed.

ARGUMENT

Petitioner urges issuance of the writ on the ground that the decision of the Circuit Court of Appeals is in conflict with the decisions in *Salvage v. Commissioner*, 76 F. (2d) 112 (C. C. A. 2d), affirmed, 297 U. S. 106, and *Robinson v. Commissioner*, 59 F. (2d) 1008 (C. C. A. 6th). The allegation of conflict with these decisions indicates a misapprehension of the basis upon which the present case was decided below.

The *Salvage* and *Robinson* cases merely hold that where a corporation sells an officer or employee shares of its stock at a "bargain price", without

having given him any antecedent option to purchase the shares of stock, the basis of the stock for purposes of determining capital gain or loss upon its subsequent disposition is the fair market value of the stock at the time of the bargain purchase.

The court below did not reject the rule enunciated in these cases. It held, however, that the rule is inapplicable where, as here, the sale of stock by the corporation was made pursuant to an antecedent option. In such a situation, the court held, the additional compensation, if any, given by the corporation to its officer or employee is the value of the option at the time of its issuance and not the differential between the option and market price of the stock at the time of the exercise of the option. In this view, if, as must be assumed to be the case here in the absence of proof to the contrary, the option had no ascertainable market value at the time of its issuance, the officer or employee received no additional compensation from the corporation, even though, due to subsequent market fluctuations in the value of the stock, the option later became of substantial value. Cf. *Palmer v. Commissioner*, 302 U. S. 63. The court held, therefore, that under the particular facts of this case the taxpayer had not proved that he had received additional compensation and that the cost basis of the stock must consequently be deemed to be the amount of the cash which he paid for the stock.

This holding of the court below is not in conflict with any decision of this Court or of any other Cir-

cuit Court of Appeals and it presents no question of general importance.

CONCLUSION

For the reasons stated, we respectfully submit that the petition for a writ of certiorari should be denied.

FRANCIS BIDDLE,
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SEWALL KEY,

HOWARD D. PACK,

Special Assistants to the Attorney General.

JUNE 1940.

